Is active investing a zero-sum game?

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Some argue that active management is a zero-sum game. They claim that passive investing - i.e. relying on the wisdom of crowds, and following the herd - is better. According to passive investors, it's all about the fees. What's the logic behind this view? Today I argue that it is more complex than it seems.

Active vs passive

One of the arguments put forward in favour of passive management is that active investors in aggregate earn the same average return (before fees) as passive. According to this theory, investors may as well save time and money by relying on the wisdom of crowds, and just mimic the market portfolio. How wise is a crowd? And, is active investing really a zero-sum game anyway?

The crowd of investors

Outperforming market benchmarks is difficult

One thing we can say for sure is that the crowd of investors believe it is highly difficult to consistently outperform market benchmarks. Indeed, some active investors do manage to win consistently, but nobody claims it's easy.

On the other hand, while markets are broadly efficient (most of the time), no market is completely efficient. All markets are subject to occasional bouts of the madness of crowds - economic and market bubbles (and their subsequent crashes) being among the obvious examples. Hence, investment markets never reach the stable equilibrium of classical economics i.e. when every security is fairly priced based on all available information.

Investment markets never reach the stable equilibrium of classical economics

Active management is not a zero-sum game

Whilst it is true that consistent outperformance is highly difficult, the difficulty of active management does not, therefore, stem from there being no mispricing to exploit. The zero-sum nature of active investing does not mean there are no ways to win. The efficiency of any given market depends on many factors: market concentration, breadth of broker coverage, liquidity, complexity and so on…

The logic behind the wisdom of crowds

In my view, part of what makes a crowd wise is the diversity and independence of the many different investment approaches taken. As such, the strength of the wisdom of crowds' argument varies across different markets and it varies across time.

Limitations of the zero-sum game claim

The ‘active management is a zero-sum game' argument can be true at times, but never completely so. Markets and investors are too complex.

1. Investors don't all have the same goals

Few investment decisions are based purely on return considerations; most also involve some risk analysis and/or other factors. Occasionally, return considerations may not be a factor at all (for example, central bank action in currency markets is often driven by policy goals, not return expectations).

2. Some investments are more similar than others Not only does it matter how similar/dissimilar investors are, it also matters how similar/dissimilar investment choices are. Bonds and stocks for example, are very distinct assets, offering significantly different expected returns and risks. Different types of investors will favour one or the other depending mainly on their own circumstances. The wisdom of crowds doesn't typically help with that decision.What's true of the stock vs bond decision is also true within the broad bond market. Long-dated bonds, short-dated bonds, high quality corporate, government bonds, high yield, overseas debt: these are all quite different from one another and serve different purposes. The allocation across distinct types of fixed income investment should generally be driven by investor characteristics, not by market capitalisation.In contrast, if investment choices are less distinct (perhaps two bonds with similar yields and maturities issued by similar corporations, or two large cap UK equities in the same sector) then it seems less likely that an investor's characteristics should drive the decision. This is why passive investing is more common within an asset class than it is across asset classes.

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3. Passive investment requires a clearly-defined opportunity set Furthermore, we need a clearly-defined opportunity set or benchmark index against which to manage passively. A portfolio of non-government bonds, for example, is so dependent on how you define the opportunity set, that it's not really the wisdom of crowds that you need to worry about here but the wisdom of credit rating agencies.Index weights should reflect the holdings of an appropriate group of investors in aggregate. While this is clearly not a problem for traditional listed markets, there is no straightforward measure of market capitalisation for commodities, for example.Therefore, the strength of the argument that active management is a zero-sum game also varies depending on the investor and the asset class in question.

The bottom line

The answer to the long argued ‘active vs passive investing' debate is not clear cut, and it may never be. Even though the primary argument for a passive approach (that it is cheap) is a simple and strong one, other arguments — such as the zero-sum game argument — are more complex. That's why, at Russell Investments, we believe there is a case for both. When it comes to achieving outcomes, there is no purely passive approach. We're all active investors. And we believe the best plan is not to follow trends, but to focus on proven, research-based strategies that give investors the highest likelihood of reaching their outcomes.

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